2. <u>Alternatively, Productivity Could Be Set Equal To The GDPPI Inflation Factor (¶¶ 231-235)</u>

The price reductions caused by the productivity factor are <u>in addition</u> to the price reductions given in response to market demands. Thus, under the current price cap plan, we must absorb both the financial impact of competition <u>and</u> the application of a formula that was intended to act as a surrogate for competition. We propose to eliminate the GDPPI minus X equation similar to action taken in California in 1995.[78]

The dual forces of competition and X-factor formula cause perverse results. GDPPI minus X requires anticipated productivity gains to be distributed evenly across baskets. Therefore, even though the targeted price reductions forced by competition may erode our earnings severely, application of this equation may mandate additional price reductions. The additional price reductions can jeopardize our financial integrity, despite our best efforts to minimize production costs in all aspects of our operations.

There is evidence that LEC productivity results will be reduced by the market changes envisioned in Phase 1. Christensen's analysis[79] indicates that the restructuring of access charges could cause measured productivity to slow by about 0.4%. This deceleration comes about from a shift in revenue sources from rapidly growing demand units (minutes of use) to slower growing or declining demand units (presubscribed lines, public policy funds, universal service funds). And as LECs lose market share, productivity can slip by another 0.6% to 1.0% for every 1% decline in output growth.

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[78] In eliminating the GDPPI -X formula at the state, the CPUC found that "Since Pacific has already become highly efficient, additional efficiencies will be more difficult to achieve." Investigation on the Commission's Own Motion into the Second Triennial Review of the Operations and Safeguards of the Incentive-Based Regulatory Framework for Local Exchange Carriers, D. 95-12-052, 1995 Cal. PUC LEXIS 1015.

[79] Christensen Attachment 5 to USTA Comments, pp. 7-9.

Together these factors cause TFP to decline by 1.0% to 1.4%; the loss could be higher depending on competitive assumptions.

The long term growth in telecommunications total factor productivity has exceeded the U.S. economy's productivity by about 2%. With LEC productivity dropping by 1.4% the productivity margin of the LEC industry is eroded sharply and the continued role of X in the price cap formula is questionable. With GDPPI minus X eliminated, Pacific assumes the risk of inflation. If inflation rises and the pressure on costs accelerates, Pacific has no automatic recourse to higher rates. A constant price over an extended period guarantees that real prices will fall at the rate of inflation. Therefore, not changing prices is equivalent to an indexed price cap where the productivity factor equals the rate of inflation.

Setting GDPPI equal to X, or its elimination, removes a growing source of controversy -- the measurement of productivity. Dr. Christensen for USTA has developed a comprehensive measure of LEC TFP. This model utilizes economic concepts appropriately and is fully documented and verifiable. In contrast, the IXCs have developed estimates of productivity that are wholly inadequate. The AT&T model, for example, is so filled with such serious logical and methodological errors that its results are virtually useless for regulatory purposes. Dr. Christensen critiques this model and documents its many faults, in Attachment 6 to USTA Comments.

Even by setting the X factor equal to GDPPI, we will continue to have incentives to operate efficiently. Competition has taken the place of the price cap formula to provide an incentive for us to operate efficiently. We know that we must continue to be efficient, or lose. In order to profit, we will have to overcome inflation, a substantial risk that we would assume under an approach that set productivity equal to the GDPPI inflation factor. An artificial X factor is unnecessary.

3. Sharing Should Be Eliminated From The Price Cap Plan

As we have stated in the 94-1 docket, sharing has no place in a properly crafted price cap plan. Sharing serves to recapture the efficiency gains made by the carrier and deprives the LEC of the benefits of those gains. By eliminating sharing, incentives for efficiency will be maximized. Sharing also discourages new deployment of infrastructure and technology. By capping overall returns, and not just prices, sharing handicaps the LECs' ability to attract the tremendous sums of capital that infrastructure investment requires. Moreover, sharing increases administrative burdens on carriers and the Commission. Its elimination would free the Commission from having to micromanage and review a complex and often politically motivated system of cost allocations. Fourth, the measurement of interstate earnings, which result from subjective and sometimes arbitrary judgments about separations and depreciation rules, is increasingly devoid of economic meaning.

In addition, the purpose of the sharing mechanism was to provide a "backstop" for errors in the Commission's estimates of LEC productivity.[80] This is no longer a concern after 7 years of actual experience under price caps. And, with the proposal herein to eliminate the productivity factor, or to set it equal to inflation, no backstop is necessary. Sharing is a throwback to rate-of-return regulation, which has no place in a pro competitive, deregulatory market.

4. There Is No Basis to Reinitialize Price Cap Indices Based for a New Rate of Return Prescription

As the Common Carrier Bureau observed in the Notice announcing its Preliminary Rate of Return Inquiry,[81] the Commission's rate of return prescriptions have little relevance to price cap carriers. Moreover, the Commission itself recognizes that any attempt at represcribing price cap

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[80] *LEC Price Cap Performance Review*, CC Docket 94-1, *First Report and Order*, released April 7, 1995.

[81] DA 96-139 (Released February 6, 1996).

carriers' rate of return must take into account not only changes in the cost of capital, but also the new competitive environment.[82] Pacific believes that, given the demonstrated level of existing competition in California, its stockholders' return should appropriately increase as a result of increased risk. Nonetheless, since rate of return represcriptions are not directly relevant and do not trigger decreases in the price cap indices, this issue is moot.

VIII. LECS ARE ENTITLED TO FULL COST RECOVERY OF CURRENT COSTS AND CAPITAL DEPRECIATION RESERVE DEFICIENCY AMOUNTS (¶¶ 241-270)

Whatever new structure is put into place as a result of this proceeding, the Commission must address how to compensate LECs for the difference between current revenues and the revenues that revised access charges are likely to generate. As shown earlier, the Commission also has a duty not to shift revenue requirements or adjust separations without referring the matter to a Federal-State Joint Board under section 410(c).

A. Recovery Of All Costs Is Compelled By The Communications Act And Is Necessary To Avoid An Unconstitutional Taking Of ILECs' Property (¶¶247-260)

The Commission asks whether incumbent LECs are entitled to recover all or a portion of the difference between their interstate-allocated embedded costs and "forward-looking economic costs" that might result from any new access charge framework.[83] As discussed below, the Commission is legally obligated under the Communications Act to permit ILECs to recoup all costs, including embedded costs such as those costs associated with underdepreciation of assets, which will not be recovered through other regulatory mechanisms including universal service support funds. In addition, the failure to allow recovery of all embedded costs would amount to an unconstitutional

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82 *Notice* ¶ 228.
83 *Notice* ¶ 256.

taking of ILECs' property without just compensation and break the long-standing "regulatory bargain" between incumbent local exchange carriers and the Commission. In the Affidavit of Sidak and Spulber attached to the comments of USTA, compelling arguments are made as to why LECs are entitled to receive all of their economic costs, both forward looking and historic.

Recovery of all costs is required in establishing "just and reasonable" charges pursuant to Section 201(b) of the Communications Act.[84] ILECs have incurred significant actual costs in developing and maintaining high quality service to all consumers at prices established by the Commission and state regulatory entities. ILECs have been unable to recover all of these actual costs as a result of unrealistically long depreciation schedules and the failure of such schedules to account for decreases in asset value with technological innovation and competition. Therefore, any rate or charge for access service that fails to include such costs cannot be "just and reasonable" because ILECs would be denied costs incurred with the assurance of recovery, including a fair return on investment.

Further, it is settled that the Fifth Amendment requires that a utility must be permitted to charge rates that are sufficient to maintain financial integrity, attract capital, and compensate investors for their risk-adjusted investment.[85] The constitutional issue is particularly acute with respect to embedded costs in the telecommunications industry given the historical relationship between carriers and regulators under which ILECs agreed to provide quality service at affordable prices to all consumers in exchange for the opportunity to recover compensation for providing service and a competitive return on invested capital.[86]

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[84] 47 U.S.C. § 201(b).

[85] *See Duquesne Light Co. v. Barasch,* 488 U.S. 299, 310 (1989); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).

[86] Sidak & Spulber, attached to Comments of USTA

The magnitude of the differential between ILECs' actual embedded costs and "forward-looking" costs can be dramatic. For example, Pacific's current costs for an analog switch port are about $500. The forward-looking cost of that port, based on digital technology, is only about $20. Limitation of Pacific's access cost recovery to $20 would deny it compensation for its actual, prudent expenditures—that could not be recovered more quickly due to regulatory constraints—much less permit it a reasonable profit. Thus, the failure to allow ILECs to recover all such embedded costs would negate their reasonable expectation to receive a competitive return on invested capital, thereby denying ILECs the ability to receive just compensation for their property.

B. <u>The Capital Reserve Deficiency Is Substantial And Must Be Recovered (¶¶249-255, 266-270).</u>

The Commission notes that under depreciation can occur (1) if the useful lives prescribed for regulated facilities exceeds the economic lives of those facilities; and (2) if the depreciation procedures do not recognize the decline in the economic value of plant already in service that occurs when the replacement cost is less than the cost of the older equipment.[87] We agree.

In 1995 Pacific Bell discontinued use of SFAS 71 and recognized a one-time charge to our external financial reporting of $5.7B pre tax and $3.3B after tax. That charge recognized that regulation may no longer assure recovery of total investment on our books. Pacific currently carries a significant reserve deficiency on its regulatory books because past FCC depreciation practices have not allowed us to depreciate our assets as fast as these assets were losing value due to technological obsolescence, and due to the impact of increasing competition. The study we have undertaken to quantify the reserve deficiency differs from the method used by the USTA in its filing with respect to how and when the deficiency is recognized. Pacific has chosen to reflect the entire amount as an

[87] *Notice* ¶ 251-253.

immediate impairment of our assets, while USTA has viewed the deficiency over the remaining lives of these assets. Pacific's reason for recognizing the entire deficiency today is our assessment of continuing regulatory burden in the increasingly competitive environment in which we operate; it recognizes the unique competitive pressure we face in California. As we lose customers and revenue to competition we lose the ability to recover these investments. Our calculation of our reserve deficiency is $4.4B, the interstate portion of which is $1.0B. See Declaration of Terry Orr, attached. The USTA method, on the other hand, yields a calculation of $2.3B, the interstate portion of which is $500M. While that number is included in the USTA industry roll up, the greater number of $1.0B is more appropriate for a competitive environment such as California.

Recovery of dollars due to the capital depreciation reserve deficiency should be accomplished via a 5 year amortization, as USTA has proposed.

C. The FCC's "Market-Based" Transitional Mechanism Will Not Permit ILECs to Recover All Remaining Costs (¶¶260-270)

In its Notice, the Commission also seeks comment on the proper recovery mechanism in the event that it determines that incumbent LECs are permitted to recoup all or part of the difference in "revenues generated by access charges based on embedded and forward-looking costs."[88] In particular, the Commission seeks comment on both a so-called "market-based" recovery mechanism and a more regulated approach, which could include recovery through an amortized schedule recovered through access charges or a separate "surcharge" to recover all interstate allocated costs.[89]

While a market-based approach is necessary for pricing, the Commission cannot adopt a "market-based" transitional mechanism because that does not allow ILECs to recover all remaining

[88] *Notice* ¶ 260.
[89] *Notice* ¶¶ 261-265.

embedded costs. As the Commission characterizes its "market-based" approach, an ILEC would be given "pricing and rate structure flexibility" and the "opportunity to reduce their cost of service levels" during a transitional period while competition is "still developing."[90] The Commission's approach thus assumes that incumbent LECs can successfully recover embedded costs from some segment of subscribers after the FCC has removed previously existing cost-recovery mechanisms. However, this approach will not work due to existing competitive pressures in the market for access services. Moreover, as the Commission acknowledges, any increase in the percentage of costs allocated to the intrastate jurisdiction might further exacerbate the difficulty in giving incumbent LECs a "reasonable opportunity" to recover all or some of their embedded costs.[91]

As noted earlier, competition in the access service market in California is already underway, particularly with respect to low-cost, high-volume customers such as large businesses and interexchange carriers in major metropolitan cities.[92] The fact that competition exists in California today means that Pacific does not have the luxury of pricing "flexibility" that would be sufficient to allow the recovery of its embedded costs. Instead, Pacific will be faced with increasingly downward pressure on access rates for customers served by competitive providers, and other customers -- including residential and small business subscribers -- will remain as the only market where it may recover embedded costs. Such an approach, however, would not only unfairly burden a limited group of customers, but would also make full recovery impossible given the limited ability of these customers to absorb the anticipated revenue difference. Accordingly, the Commission must adopt a

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[90] *Notice* ¶ 261.
[91] *Id.*
[92] See Section IV, supra.

recovery mechanism that ensures Pacific and other ILECs an opportunity to recoup such costs in a manner that is equitable to both the local exchange carriers and ratepayers.

D. Universal Service Support Will Not Amount To Double Recovery For Access Charges (¶¶242-246)

Carriers will receive payments from the universal service fund when serving high cost customers that meet the criteria established by the Commission in the Universal Service proceeding. The Commission seeks comment in this *Notice* about how the price cap indices will be adjusted to account for any proceeds from the new universal service fund.[93] We agree with the Commission that a downward exogenous cost adjustment is appropriate to reflect any additional revenues received from the fund, as long as two conditions are met. First, the downward exogenous adjustment should be made only to the extent there is a net revenue increase to the carrier from the fund. Second, to the extent a LEC is precluded from directly passing through its contribution amount to its customers (through a surcharge or other customer charge), an upward exogenous adjustment should be made.

Section 254 of the Act requires the Commission to institute a universal service plan which, on the basis of nondiscriminatory and equitable payments provides specific and predictable support mechanisms to ensure service in rural and high cost areas. The Commission in this *Notice* seeks comment on whether the retention of the current access charge system, such as the CCLC, could compensate incumbent LECs twice for providing universal service, and what steps the Commission could take to address any potential double recovery.[94] The exogenous adjustments we have outlined above ensure that no double recovery will occur.

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[93] *Notice* ¶ 245.
[94] *Notice* ¶ 244.

The universal service support mechanism takes into account the revenue received for serving the customer, from whatever source that revenue originates. Thus, for a residential subscriber, the monthly basic service rate, the SLC and the CCL-equivalent charge (whether assessed per minute or via a bulk-billed amount) are included in the subsidy calculus. A carrier will not be overcompensated as long as the universal service fund includes both costs incurred and revenues received and adjustments are made to correct access charges to reflect Universal Service funding. Not only will a carrier not be overcompensated in this situation, but if the Joint Board recommendation is adopted without modification, rates will necessarily continue to include subsidies due to the Joint Board's proposed inclusion of inappropriate and subsidizing rates in the benchmark formula.[95]

E. Future InterLATA revenues cannot recover embedded costs (¶256)

The Commission's own rules, discrimination standards, and market conditions in the interLATA market foreclose the use of an affiliate's interLATA revenues to fund shortfalls in access recovery. At the outset, it should be noted that any such scheme would amount to nothing more than an increase in access charges to the BOC's interLATA affiliate, as compared to the access rates faced by other interLATA providers. This could in no way be squared with the Act's fundamental discrimination standard that interLATA providers should face the same charges for access to the local network. Moreover, singling out the BOC affiliate in this fashion would simply force the BOC to charge more for the toll it offered to end users, thus hurting both competition and consumers. Such an outcome would thus bear the negative marks of being unlawfully discriminatory and harmful to competition and end users.

[95] The Joint Board incorrectly recommended that the benchmark be set at the nationwide average revenue per line, which includes revenues generated by discretionary services (such as call waiting, caller ID, and others) and access services. See Comments of Pacific Telesis Group filed in Universal Service Docket, CC Docket No. 96-45, filed on December 19, 1996.

In addition, in the Commission's recently released order in Docket 96-150 (Accounting Safeguards), as well as Docket 96-149 (Structural Safeguards), it has made clear that the interLATA affiliate has to operate on a separate basis from the BOC. The Act itself requires this same standard (See Section 272 and the "operate independently" rule). As a legal matter, the BOC's interLATA affiliate must operate as a completely separate entity, with strictly separate books of accounts from the BOC. Since this separation is required by law and the Commission's own decisions, there is no legal basis for undoing these requirements and forcing the BOC's affiliate to specially fund the BOC's cost of providing local access to interLATA toll providers.

Finally, there is good reason to conclude that the interLATA toll market cannot sustain a special funding obligation placed only on BOC interLATA affiliates.

The prospect of future revenues from a BOC affiliate's interLATA services is not a solution to the need to recover today's costs with today's access charges. The Commission has already found the interLATA market to be competitive though, as we point out elsewhere, there is great reason to question whether consumers are seeing any benefit from this "competition". With additional LEC entry, that market will become more competitive and consumers will actually be benefited. Under such a market condition, LECs' interLATA affiliates can reasonably hope to recover forward-looking costs and reasonable profit from interLATA service itself, but will have no ability to recover the remaining interstate-allocated embedded costs of access service.

Moreover, the Commission, in its non-accounting safeguards order, has made it virtually impossible for a BOC to use facilities it now owns to provide interLATA services to its affiliates or others notwithstanding that the Act envisions that a BOC may provide interLATA facilities and services to its interLATA affiliate and to other interLATA carriers.[96] While this would possibly allow BOCs to derive an additional source of revenue from its existing plant with some incremental investment, the Commission has ruled that the Act does not allow the BOC to use its facilities in this way.[97] Thus, under the Commission's reading of the Act, it will be impossible for a BOC to realize any interLATA revenues that could ameliorate any shortfall in access revenues. In any event, even this approach envisions like charges to the BOC's interLATA affiliates and its competitors.

IX. CARRIERS SHOULD NOT BE ALLOWED TO ENGAGE IN UNECONOMIC ARBITRAGE UNDER THE COMMISSION'S RULES AND AVOID PAYING THEIR FAIR SHARE OF UNIVERSAL SERVICE OBLIGATIONS BY USING UNBUNDLED ELEMENTS TO PROVIDE EXCHANGE ACCESS SERVICES (¶54)

The Commission must reconsider its tentative conclusion that carriers purchasing unbundled elements for use in providing exchange access services should be excluded from the access charge regime.[98] Access rates have never been determined solely based on costs, unlike unbundled elements, but have been set at their current levels to satisfy a number of social policy goals. Allowing carriers to avoid paying these charges will undermine universal service supports, prevent ILECs from recovering their costs, and cause inefficient entry into the exchange access market.

In its *Local Competition Order*, the Commission attempted to make a similar finding. Rule 51.515(a) states that "[n]either the interstate access charge described in part 69 nor comparable intrastate access charges shall be assessed by an incumbent LEC on purchasers of elements that offer telephone exchange or exchange access services." However, that rule was stayed by the Eighth

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[96] 47 U.S.C. §227(e)(4).

[97] *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934*, CC Docket No. 96-149 (First Report and Order and FNPRM) (Dec. 24, 1996) ¶¶ 259-267.

[98] *Notice* ¶ 54.

Circuit.[99] Because of this stay and because "access charges have always played a complex and critical role in the recovery of embedded network costs," the CPUC recently decided to apply access charges to unbundled elements used for toll calling.[100] Indeed, the FCC itself noted that a transitional mechanism was needed before access charges could be eliminated from unbundled elements used to provide exchange access because "allowing such a result before we have reformed our universal service and access charge regimes would be undesirable as a matter of both economics and policy, because carrier decisions about how to interconnect with incumbent LECs would be driven by regulatory distortions in our access charge rules and our universal service scheme, rather than the unfettered operation of a competitive market."[101] Until (1) the pricing policies governing access and unbundled elements are conformed, (2) ILECs are provided with another mechanism for recovering their actual embedded costs, and (3) the universal service funding mechanism is made explicit and predictable as required by Section 254, carriers using unbundled elements to originate or terminate toll traffic should be required to pay the difference between the cost of the unbundled network elements and the access charges they would be required to pay if they purchased such services directly from the ILEC.

A. The Current Access Charge Rules Include Actual Costs As Well As Several Subsidies In Access Rates To Support Below-Cost Residential Telephone Service Rates (¶54)

The current access charge regime is designed to keep local service rates below cost through higher long-distance charges, not to approximate the actual costs of providing exchange access

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[99] *Iowa Utilities Board v. F.C.C.*, Nos. 96-3321, et al. (8th Cir., Jan. 6, 1997)

[100] *In the Matter of the Petition of AT&T Communications, Inc. for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with Pacific Bell*, D.96-12-034, at 19-20 (December 9, 1996), appeal docketed, *AT&T Communications of California, Inc., v. Pacific Bell* (N.D.Cal. January 8, 1997).

[101] *Local Competition Order*, ¶ 719.

services. Access charges are based on fully distributed cost (FDC) pricing, including recovery of ILEC actual costs, all of which would have been disallowed under the Commission's unbundled element pricing rules had they not been stayed. In adopting the FDC method, the Commission concluded that although costs should be the basis for determining rates of particular services, "statutory and social policies may lend sanction to some intraservice subsidies."[102] Access charges are now regulated under the price cap regime; the rates that originally went into price caps were established by rate-base, rate-of-return regulation.

In addition to keeping local rates below cost, access charges contain subsidies used to support several aspects of universal service, including service to high-cost areas.[103] For example, the high cost assistance fund allows LECs with above-average loop costs to recover their additional costs, with each LEC's embedded costs determining the support payments the LEC will receive. Lifeline and Link Up provide IXC funded support for low income individuals. Also, DEM weighting allows smaller LECs to attribute a greater portion of local switching costs to the interstate jurisdiction. The actual DEMs are weighted to shift costs that would otherwise be attributed to the intrastate jurisdiction to the interstate jurisdiction.[104] In addition to these explicit subsidies, the residual loop costs are not recovered fully through the subscriber line charge and are thus recovered through the CCLC.

The current separations rules allocate 25% of exchange loop costs to the interstate jurisdiction, where they must be recovered from access charges.[105] This percentage is substantially

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[102] *In the Matter of American Telephone & Telegraph Company, Long Lines Department*, 61 F.C.C.2d 587, 588 (1976).

[103] *Notice* ¶¶ 27, 36-40.

[104] *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, at ¶¶ 187-190 (rel. Nov. 8., 1996).

[105] 47 C.F.R. Part 36.631.

greater than the relative usage of joint plant for access purposes.[106] Because of this, the access charges that must be assessed to cover the costs assigned to the interstate jurisdiction are greater than the actual costs of providing that service. Therefore, even if interstate access charges were based on the same definition of recoverable costs as unbundled elements, these charges would still be higher than actual costs incurred to provide access because such charges would be set to recover 25% of the costs of jointly used plant rather than the much smaller percentage that is actually used to provide interstate service.

B. Permitting Carriers To Avoid Access Charges By Purchasing Unbundled Elements Will Allow Them To Avoid Contributing Their Fair Share To The Provision Of Low Cost Residential Service While Preventing ILECs From Recovering Their Costs And Competing In The Exchange Access Market (¶54)

Access charges are virtually the only method currently authorized through which ILECs can recover the interstate allocated costs of local exchange plant, as well as the subsidies necessary to provide below-cost local service and further universal service policies. If carriers are allowed to avoid these charges through the purchase of unbundled elements, ILECs will have no opportunity to recover their costs, resulting in an unconstitutional taking, and will not have a fair opportunity to compete in the exchange access market. Under the Commission's stayed pricing rules, unbundled elements were to be priced based on only the actual costs attributable to that network element, without any of the universal service subsidies or separations adjustments discussed above. In addition, the Commission proposed that the prices for such elements should be forward-looking, and not include any embedded

[106] In the Eighth Circuit appeal of the Commission's *Local Competition Order*, several state commissions claim that interstate traffic is still only 8 percent of the total traffic. Joint Reply Brief for the State Commission Parties at 2, *Iowa Utilities Board v. F.C.C.*, Nos. 96-3321, et al. (8th Cir., Jan. 6, 1997).

costs.[107] Thus, access to the local network can be significantly less expensive when obtained through unbundled elements as opposed to switched access.[108] Such a pricing differential will encourage inefficient entry into the exchange access market, as the Commission noted.[109] Carriers will simply "arbitrage" the separations and access charge rules in order to gain less expensive access.[110] BOCs, and their shareholders, will be left with paying for the cost of such access.

Using California data for Pacific Bell, allowing carriers to obtain cheaper access through use of unbundled elements will benefit only the 30 percent of residence customers who will be targeted by CLCs. This 30 percent of the residential market makes more than 75 percent of the intraLATA and interLATA toll calls and, because access charges are usage-based, contribute substantially to the subsidies needed to preserve low universal service rates. If the Commission allows CLCs to use unbundled elements to obtain cheaper access and offer better rates to this 30 percent of the customers, the ILECs will be left with no source of funding to support reasonable rates to the remaining 70 percent of residential consumers. In order to allow recovery of ILEC costs of providing basic access, the Commission must ensure that when unbundled network elements duplicate exchange access service, the rates are the same.

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[107] *Local Competition Order*, ¶¶ 704-707. This portion of the Commission's decision has been stayed by the Eighth Circuit. *Iowa Utilities Board v. FCC, No. 96-3321, (8th Cir., Oct. 15, 1996).*

[108] Decisions such as that of the CPUC to apply access charges to unbundled elements used for toll calling may only temporarily ameliorate this effect. Interconnection Agreement Between AT&T of California, Inc. and Pacific Bell, Att. 18 (filed Dec. 19, 1996). However, Pacific Bell's ability to rely on this decision is subject to the outcome of the Eighth Circuit appeal, AT&T's appeal of the CPUC's approval of this requirement of its interconnection agreement with Pacific Bell, and, potentially, the further actions of this Commission.

[109] *Notice* ¶ 42. Facilities-based alternatives to ILEC access services are already available and can be expected to proliferate, as the cost declines. For example, MCI has indicated that a single switch can already provide access services to an area within a 150 mile radius. Testimony of Drew Caplan in CPUC Dockets R. 93-04-003 & I. 93-04-002, Open Access and Network Architecture Development (OANAD) at 594 (July 18, 1996)]

[110] *Notice* ¶ 9.

Most importantly, Congress's universal service goals require contributions by all telecommunications carriers. The Commission has yet to make a final decision how it will meet the universal service mandates included in the Act, and the Joint Board's Decision did not address the major issues regarding how the universal subsidies should be allocated. In addition, the Commission determined in the *Local Competition Order* that ILECs' embedded costs should be recovered through universal service and access charge reform.[111] Because access charges have historically—and will continue in the near future—to be the most important source of universal service funding and embedded cost recovery, the Commission must consider how it will structure these subsidies before fundamentally altering the access charge regime. In the interim period, if carriers are allowed to circumvent the access charges, ILECs will have no incentive to invest in their networks and will be unable to continue to provide affordable local service.

C. Until Such Time As Access Charges Are Priced Consistently With Unbundled Network Elements, Carriers Using Unbundled Elements To Obtain Exchange Access Service Should Be Required To Pay The Difference Between The Cost Of The Unbundled Network Elements And The Access Charges They Would Be Required To Pay If They Purchased Such Services Directly From The ILEC (¶54)

Even if the Commission is ultimately able to make access charges cost-based, implement a separate scheme for the recover of ILECs' embedded costs, and revise the separations rules so that they accurately reflect the way costs are incurred, a transition period will be required. During this period and until such time as all the necessary adjustments have been made, the Commission should require that carriers using unbundled elements for exchange access pay the difference between the cost of the unbundled elements and the access charges they would have otherwise incurred. This will ensure that each carrier is contributing its fair share to the support of

[111] *Local Competition Order*, ¶ 707.

universal service and that the ILECs have the opportunity to recover their costs and compete in the exchange access market.

Such an approach will not require extensive and intrusive Commission rules. In order to further its goal of limiting regulation and recognizing that competition in all telecommunications markets will continue to increase, the Commission should simply require that the difference between the ILEC's access charges, regardless of whether they are determined by the market or by the Commission, and the cost of access through unbundled elements be paid to the ILEC. The ILEC and interconnecting carrier should be allowed to determine the actual rates through negotiations and interconnection agreements. Since state commissions must review all interconnection agreements, there will be sufficient oversight to ensure that AT&T, MCI, and other CLCs do not use their purchasing power to force the majority of these costs on to the 70 percent of customers they do not intend to serve. The Commission should note that although Pacific strongly believes that a market-based system is best for determining access charges, this approach is consistent with either market-based rates or Commission-set rates.

X. RATE STRUCTURE MODIFICATION

The current rate structure has been in effect for approximately 13 years. Those 13 years have seen tremendous change in the telecommunications industry. The access charge structure must reflect today's competitive environment, where users should pay for the costs they incur, and subsidies should be uncovered and made explicit. We generally support the structure proposed by USTA in its Comments.

We agree with the Commission that whichever approach to access restructure is chosen, prescriptive or market-based, more economically rational rate structure rules are necessary and appropriate. Our proposal is as follows: First, to the extent possible the CCLC should be reduced or eliminated. This can be accomplished by increasing the SLC caps, or by allowing the multi-line SLC to increase to its cap. Any residual CCL should be recovered on a bulk-billed basis from access customers on the basis of presubscribed lines. Second, rate elements should be charged in the way the costs are incurred; for example non-traffic sensitive costs should be charged on a flat-rated basis, and usage sensitive costs should be recovered on a usage sensitive basis. Third, we support reallocating portions of the TIC to their appropriate elements that better reflect cost causation. The remainder of the TIC should be bulk-billed to access customers based on interstate revenues.

A. Common Line Costs Should To The Extent Possible Be Charged To End Users And Should Be Permitted to be Deaveraged (¶¶ 57-70)

Common Line costs are currently recovered through a flat-rated end user charge, the SLC, and through a usage sensitive charge, the CCLC. SLCs are limited to the lower of the per-line cost of the interstate portion of the local loop or $3.50 per month for residential and single line business users, and the lower of the per-line cost or $6.00 per month for multi-line business users. Any residual amounts resulting from the imposition of the cap is recovered through the CCLC, which is a per minute charge levied on access customers.

The fundamental repricing ordered by the Telecommunications Act was to eliminate subsidies, make them explicit, and collect them from all carriers on a competitively neutral basis. We agree with the FCC's fundamental goal that prices move towards cost and subsidies be removed; economics dictate this. If prices on services which provide subsidies move toward cost, however, then prices on subsidized service (consumer prices) must equivalently move toward cost or a subsidy mechanism must be developed which includes 100% of the subsidies instituted by the regulators over the last 50 years. Pacific has been a leader in championing alternative, subsidy mechanisms, at the state and federal levels. But, in the absence of a sufficient fund or funds, the prices of subsidized services must be increased to assure full cost recovery. Our position therefore includes an increase in the SLC.

As Chairman Hundt said in 1995,

> We need to fix the Carrier Common Line Charge. This part of access charges works to make high-volume users subsidize lower-volume users.... as competition hits the local exchange market the system cannot continue. The fact is that the CCLC tends to drive access charges way above cost....
>
> If we fix the CCLC, then obviously we need to take a hard look at the hard caps on the Subscriber Line Charge. These charges are the two sides of the coin paid for access. Internet customers pay a flat rate; isn't it time to rely more on flat rates in local loop pricing? We need to find ways to let the subscriber line charge caps approximate economically rational pricing for consumers and single line businesses....
>
> We should be concerned about price shocks rocking consumers. But, we shouldn't be concerned about nickel and dime differences on the local telephone bill at the expense of having rational pricing.[112]

We agree with Chairman Hundt that the CCLC is unsustainable in a competitive environment. Increasing the SLC may be the only way to encourage prudent investment in the network by allowing carriers to recover their costs. We also propose that LECs be permitted to deaverage the SLC to better reflect the variability of loop costs. Such a charge would be competitively sustainable in that end users would be paying for the interstate portion of the costs incurred to serve that end user.

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[112] Address of Reed Hundt, Chairman, FCC, to Fall Business Conference, Competitive Telecommunications Association, October 10, 1995.

1. The Subscriber Line Charge ("SLC") Rate Structure Should Be Modified and Geographically Deaveraged (¶¶57-67)

One approach for common line recovery is to eliminate the arbitrary cap of $3.50 per month on residential and single line business subscribers. The $3.50 cap was instituted in 1989 as a transition method for recovering non-traffic sensitive loop costs directly from the cost causers--end users. Beginning in 1985, the SLC was set at $1.00 per line, then transitioned to $3.50 over 4 years. Since 1989, the SLC cap has been set at $3.50 and has not increased, even to keep pace with inflation.[113] If the $3.50 cap were eliminated, and the $6.00 cap retained for all customers, the Pacific Bell geographically averaged SLC price for all business and residence customers would be only $4.75. The total price effect on consumers would be minimal,[114] but the overall effect would be positive. It has been shown that during the 1980s, increasing line charges and decreasing toll charges did not merely balance one another out, but led to overall increases in consumer welfare.[115]

Treating residential and business subscribers similarly is justified by the continued blurring of the line between the two. Increasingly, residential subscribers, through telecommuting or work-at-home programs, use the residence line for business purposes. National market research estimates that over 5.5 million households in California, and over 40 million households nationwide, perform some work at home.[116] A significant number of work-at-home households require multiple lines to accommodate faxing, networking, and paging. The current FCC rules, which set separate SLC costs for residence and single line business, and multi-line business, are based on a technological past

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[113] If the SLC were tied to the inflation rate the current residential and single line SLC charge would be approximately $4.25.

[114] Pacific Bell's current rate for one party flat rate residential service is $11.25, among the lowest in the nation.

[115] See J. Hausman, T. Tardiff, and A. Belinfante, *The Effects of the Breakup of AT&T on Telephone Penetration in the U.S.*, American Economic Review (1993).

[116] *Home Office Market Forecast, 1995-2000*, prepared by IDC/Link #11439, July 1996.

where home offices were unusual, where most households purchased few telecommunications services beyond a single primary line and perhaps a few room extensions, and where that home line was almost never used for business purposes. By maintaining this artificial distinction in its pricing structure, the FCC is ignoring the technological and workplace revolution which has swept the U.S. over the past decade; it is holding on to a pricing structure impossible to maintain and easy to abuse.

It also is increasingly difficult to decide which lines are reserved for residential versus business usage; indeed many lines labeled "residential" today are used as much or more for business purposes as for other purposes. Thus, the distinction of residential over single line business versus multi-line business is becoming meaningless as household telecommunications moves increasingly toward multiple lines used for a multitude of purposes.

If the Commission is unwilling to eliminate the $3.50 cap for residence and single line business, we support in the alternative eliminating the limitation that requires the multi-line business SLC to be the lower of the $6.00 rate cap or the calculated rate per 47 C.F.R. 69.104(c). Over 40 states have multi-line SLC rates that are at the $6.00 cap. Pacific's are substantially below the cap ($4.75). As the experience of most of the rest of the country illustrates, permitting us to raise the SLC to the $6 cap will not adversely affect consumers and will permit costs to be shifted toward the end user customer.

SLCs should be permitted to be geographically deaveraged, whether or not the caps for residence or multi-line business are adjusted. Geographic deaveraging is necessary to reflect the variation of costs with population density and geographic characteristics. Pacific Bell's recent (January 13, 1997) compliance filing at the CPUC reflected geographically deaveraged loop costs--further proof that SLCs should similarly be deaveraged to reflect loop cost differences. The

Commission correctly notes that geographic averaging of SLCs is one form of implicit subsidy[117] in that end users with low loop costs provide contribution to end users with high loop costs. This presents a structure which is not economically rational[118] and not sustainable in a competitive market; our competitors can easily target our high volume users with low loop costs. Deaveraged SLC pricing minimizes this effect. More flexibility in recovering loop costs will decrease incentive for uneconomic bypass of our network.

The Commission proposes to increase the cap on the SLC for second and additional lines for residential customers. Or, the Commission proposes, it could eliminate the cap completely, freeing the LEC to charge SLCs in excess of the cap to second residential lines. The Commission should not adopt these proposals. First, this policy will create severe identification difficulties when a customer obtains lines from multiple carriers because it will be impossible to determine which carrier's line is the "primary" line. Perverse incentives will result; CLCs can then target second lines in dense areas, so that both ILECs and CLCs each serve a customer with a "primary" line. Second, with multiple carriers, if the first line obtained is always considered the primary line, a competitive advantage will be accorded to the current provider. Third, as we explained in our comments in Docket No. 96-45, determining whether additional lines in a single residence actually belong to multiple households, and whether a home is a "second residence," is a nearly impossible task. Increased second line charges will be an unworkable solution, since no one will admit to owning a second line. Accordingly, the Commission should treat all lines equally and not make a distinction in the SLC cap for second lines.

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[117] *Notice* ¶ 67.
[118] Emmerson, pp. 3-4.

2. Any Residual Carrier Common Line Charge ("CCLC") Should Be Recovered On A Flat-Rated Basis (¶¶ 59-63)

In its *Recommended Decision*, the Universal Service Joint Board found that: "Because the cost of a loop generally does not vary with the minutes of use transmitted over the loop, the current CCL charge that mandates recovery of loop costs through per-minute-of-use charges represents an inefficient cost recovery mechanism."[119] We agree with the Joint Board's conclusion. We support recovering loop costs directly from loop purchasers so that residual loop costs that need to be recovered through the CCLC will be eliminated, or at the least, minimized. Under the alternatives we outlined above, we attempt to directly recover loop costs. To the extent residual loop costs remain and need to be recovered from the CCLC, we support a bulk-billing based on the presubscribed lines of a carrier.[120]

Our current CCLC for California is relatively small once the payphone elements and Long Term Support payments are excluded. We estimate that the CCLC left in our rates after these adjustments will be around $100M.[121]. Based on current presubscribed lines, the bulk-billed amount will be around $0.52 per line per month.

3. SLCs On ISDN And Derived Channels (¶¶ 68-70)

The Commission seeks comment on how the Telecommunications Act of 1996 affects how many SLCs should be applied to ISDN services.[122] As we stated in our comments in the ISDN proceeding, SLCs should be assessed on a per facility basis for both BRI and PRI ISDN service. ISDN does not change the nature of a local loop. It is a switch feature that allows the local exchange

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119 *Joint Board Recommendation* ¶ 775.

120 The Joint Board found this a promising alternative. Id.

121 Of course the CCL would be completely eliminated with the proposal set forth in section 1, above.

122 *Notice* ¶ 70.

line to be used more dynamically and efficiently, but it does not change the fact that a single local loop is in use. 47 C.F.R. 69.104 requires SLCs to be applied on "each line...that is or may be used for local exchange service transmissions." Thus, the SLC for ISDN should be based on the facilities used, not the derived channels.

The cost data noted by the Commission in the *Notice* does not change this policy. It simply reinforces that for BRI, the ISDN product most in use and most useful for consumers, the difference between NTS costs of ISDN loops and standard loops is minimal. While there is some greater difference in NTS costs where PRI is provided, any additional revenues generated from imposing several SLCs on PRI service will be minimal given the low penetration of this service.

The Telecommunications Act of 1996 does not change any of these facts. What the Act promotes, however, is the removal of implicit subsidies. If multiple SLCs were imposed on ISDN service, those subscribers would be overpaying for the costs they have caused and an uneconomic subsidy would be created. We therefore support using a 1 SLC per facility rule for all service, including services with derived channels.

The Commission also seeks comment on whether mandatory rate structures or rate caps should be prescribed for ISDN or other derived channel services.[123] ISDN is not a federal service; it is not an access service. Rather, it is a local exchange service. The FCC cannot involve itself in its regulation. In fact, just recently, Chairman Hundt gave his opinion that even states should not regulate ISDN service:

> After all, you can hardly argue either that regulation has effectively promoted this long-overdue service or that ISDN is a basic

[123] *Notice* ¶ 70.